PROPRIETORS' SALARIES

The recent income- and excess-profits-tax legislation has made the question of proprietors' salaries one of real importance. Section 214[1] of the Revenue Act of 1918 states in part "that in computing net income there shall be allowed as deductions all the ordinary and necessary expenses paid or incurred during the taxable year—*including a reasonable allowance for salaries or other compensation for personal services actually rendered.*"[2]

This statement specifically recognizes the right of the taxpayer to deduct not only the wages of ordinary employees in determining tax liability, but also fair compensation for any services which the proprietors themselves may furnish. In other words gross income may be charged for tax purposes with the salary, bonus, commission, or other remuneration paid or credited to a proprietor as compensation for his services as an executive officer, production manager, salesman, or other officer or employee.

This provision of the act, involving as it does the determination of reasonable salaries, is naturally somewhat difficult of equitable administration; it is also one of those features of the law which tend to modify accounting procedure. It is the purpose of the following pages to discuss this subject in both of these connections.

"REASONABLE" SALARIES FOR TAX PURPOSES

The above-quoted provision is now of importance primarily in connection with the so-called "close" corporation. And this type is the more numerous class; for it should be remembered that the "open" corporation—the large enterprise in which control is vested in hundreds or thousands of scattered stockholders and in which the general officers and other managers are engaged by the directors

[1] Section 234, which sets forth the allowable deductions in the case of corporations, contains a similar statement. And since single-proprietors and partners under the act of 1918 are taxed solely in their individual capacities, this matter is of present significance for tax purposes only in the case of corporations.

[2] The italics are the writer's.

by a process of arm's-length bargaining—is the exceptional rather than the usual case. The great majority of corporations are simply incorporated partnerships.[1] Many are family affairs, in which three or four relatives own all or at least a controlling interest in the capital stock. Not infrequently such family corporations are essentially one-man enterprises, or in a sense sole-proprietorships, a single individual holding from 50 to nearly 100 per cent of the outstanding shares. And it may be added that even among the large companies, where there may be a long list of proprietors, actual control often resides in a small coterie of stockholders, from among whom are likely to be selected the general officers and perhaps certain other important employees.

In the case of these "partnership corporations" there is likely to be no clear recognition—at least so far as the records are concerned—of the distinction between compensation for the personal services of the principal stockholders who may be engaged in managing the business and the distribution of profits as a return on capital invested. Indeed, for ordinary accounting purposes there may be little need for any such differentiation of earnings. Suppose, for example, that in the case of a certain corporation one individual owns 95 per cent of the capital stock, and is in addition in active control of all business operations. To this individual the earnings of the corporation are essentially his earnings, and he may not be much concerned as to whether they are distributed in the form of dividends or as salary. Such a proprietor would of course recognize the fact that the net revenue of the enterprise was the result of his personal efforts in conjunction with the capital invested and other conditions. But he is quite likely to neglect any formal division of this net result into its various economic elements. And it should be emphasized that from the standpoint of the principal owner or proprietor—and it is not entirely unreasonable for the accountant to overlook the corporate entity in such case and to view the one-man corporation as a sole-proprietorship—a charge for the owner's personal services is not an expense but an item of income.

[1] Of the 218,015 corporations filing tax returns for the year 1917 probably 80 or 90 per cent were companies of this kind.

It is not surprising to find, accordingly, that prior to the inauguration of the excess-profits-tax program the practice of deducting the proprietor's salary from gross revenue in stating net income was very imperfectly developed in the case of a majority of corporations as well as in partnerships and single-proprietorships. Only nominal salaries or even no salaries were allowed in many instances, and earnings were distributed as dividends or were accumulated. Less commonly occurred the practice of treating a very large portion, in some cases all, of the net earnings as a proprietary-salary allowance. The last usually was found in cases where a single individual owned a very large fraction of the outstanding stock. In comparatively few cases was there a clear-cut division of net earnings into distributions of profits and proprietary salaries, based on actual transactions between the corporation and the individuals involved.

The act of 1913 levied the same rate as far as the normal tax was concerned on individual net income as on corporate net income. Further, the individual was allowed a deduction for purposes of computing the normal tax equivalent to any dividends received from corporations taxable under this act. Similarly the act of 1916 provided the same rate of normal tax on corporations as on individuals, and individuals were permitted a credit for normal-tax purposes to the "amount received as dividends upon the stock or from the net earnings of any corporation, joint-stock company or association, trustee, or insurance company, which is taxable upon its net income as hereinafter provided." Prior to the passage of the act of 1917, accordingly, the division of net earnings in close corporations between proprietors' salaries and profit distributions made no difference in the total amount of tax collected (assuming that consistent returns were filed by the individual proprietor and the corporation). A sum paid to a stockholder (either actually or constructively) must be viewed as either a distribution of profits (or capital) or a compensation for services rendered. If a distribution of profits, the item is a credit on the individual's return in computing the normal tax; if the sum is compensation for services, there is no such credit. The disallowance of an item of salary as a deduction in a corporation return

would therefore give rise to an increase in tax exactly equal to the refund thereby becoming due to the individual. The government then had no object—as far as the amount of tax to be collected was concerned—in cutting salaries of corporate officials as shown in the 1916 returns. Further, the revision of salary scales was evidently not a serious matter to the corporate officials.

The act of 1917, however, provided for excess-profits taxes and increased the normal tax on corporations by 4 per cent, while that on individuals was increased by but 2 per cent, and subsequent to its passage the distinction between proprietary salaries and dividends naturally became a matter of first importance to the government and to the taxpayer. The excess-profits taxes provided by this act upon sole-proprietorships, partnerships, and corporations were evidently designed primarily as a levy on the earnings of capital as distinct from the earnings resulting from personal effort. Hence, if equitable allowances for proprietors' salaries were not made in any case, the taxpayer would be seriously disadvantaged; and if excessive allowances were approved the government would not receive the proper amount of tax.

The Revenue Act of 1918 increased the excess-profits-tax rates, but removed sole-proprietorships, partnerships, and strictly personal-service corporations from the scope of such taxes. Therefore the matter is of current importance only in the case of ordinary corporations.

Since the act of 1917 was not approved until October 3, 1917, many close corporations were somewhat tardy in taking the formal action necessary to place increases in officers' salaries within the class of "expenses paid or incurred during the taxable year." Nevertheless widespread and striking increases in corporate proprietors' salaries occurred as of 1917, and in 1918 there was a further remarkable advance in such allowances. Naturally the Treasury Department is interested in this development, and has been endeavoring to develop methods and policies for the equitable control of such cases.

The taxpayer is inclined to be very sensitive about this matter. He feels that it is not for the government to determine the salaries a corporation may pay its officers, whether they are stockholders or

otherwise. The Treasury Department, he contends, has no right and is not in a position to pass upon the special qualifications of each corporate official and his ability to earn the salary given him in any case. How far is this attitude justified?

In general it is true that the Department does not assume to have, nor attempt to take unto itself, the authority to criticize corporate or other private expenditures. A particular wage scale may be out of all proportion to the real earnings of the laborers involved; an inefficient purchasing department may mean unduly high prices for materials and supplies; over-optimism on the part of the management may lead to an unfortunate plant extension: all such outlays if made in good faith would be considered legitimate deductions for tax purposes—"ordinary and necessary expenses." It must be recognized that business conditions are so varied, technical operation is so completely coupled up with speculative economic processes, that it is out of the question to disallow such charges even though they are somewhat unusual. Even if a particular expenditure is undertaken because it is in part at Uncle Sam's expense, it is difficult to see on what basis the deduction could be thrown out. A particular concern, for example, may launch a great advertising campaign, the funds for which, were it not undertaken, would otherwise be taxable income in, let us say, the 80 per cent bracket. Or a company may embark upon a price-cutting venture, hoping thereby to destroy competition or to build up a good-will from which income may finally accrue in years of lower tax rates. Intents of this sort would be difficult to establish, and, even if established, such outlays would probably be allowed as deductions for tax purposes.

But salaries of proprietors who are virtually in position to fix their own rates of compensation are in a different category. If the contract between corporation and officer in any case were based upon bargaining in which the sole factor influencing the board of directors was the supposed value of the candidate's services, the compensation determined upon would normally be considered reasonable even if a percentage of net or gross income—or other bonus scheme—were involved which made possible a very high total. But while this condition obtains more or less perfectly in

corporations where the stock is widely held and no clique representing the personal interests of the officers is in control, in the great majority of smaller corporations the salaries of the principal officers are not at all determined by a process of arm's-length bargaining. The corporation as an entity may act formally and legally. Stockholder John Smith (who owns one-third of the stock and is treasurer of the company) may move that the annual stipend of Henry Smith (his brother, owner of another third of the outstanding stock and president of the company) be increased from $25,000 to $50,000. The motion may be duly seconded by Andrew Smith (who is secretary of Smith Brothers, Incorporated, and holder of the remaining third of the stock), and after having been put by the chairman, and unanimously carried, the proper record may be made in the official minute-book. By similar rigmarole the salaries of John and Andrew may be likewise boosted from $25,000 to $50,000 respectively. But it is evident that we have in such a case a situation in which the fiction of the corporate entity must be ignored in gauging the propriety of salary deductions, and "reasonable" salaries for tax purposes must be determined entirely outside of this corporate procedure; for such a transaction is purely an arrangement by and among the proprietors, and is not a bona fide transaction between the corporation and outside individuals.

The use of the term "reasonable" in the act clearly indicates that Congress intended that the allowances for proprietors' salaries should be controlled; and certainly where an individual is in a position to vote his own salary the amount so voted is likely to exceed a reasonable allowance. The taxpayer's intention may be entirely bona fide, but even so he is likely to be overenthusiastic with respect to the value of his own services. This is often partly due to the fact that it is very difficult for the taxpayer to disassociate his current services from current and early risk and sacrifice and other phases of his function as an investor of capital. A reasonable amount must be imputed to personal efforts, but something must be left as the earnings of capital. In a great many cases the increases in officers' salaries that have occurred during the past two years have been apportioned exactly—or nearly so—in proportion to officers' stockholdings. In such cases the suspicion is raised that

the line between true profits and compensation is not being drawn with even approximate accuracy, and that profits are being distributed under the guise of wages. Extreme cases have occurred where owners have set their salaries at *exactly* the difference between gross revenue and other charges—the result being no taxable income! Although the salary deduction in such a case need not be unreasonably large, this method of determining proprietors' compensation could hardly be approved.

It should be noted that the Treasury Department is of course not interested in corporate expenditures as such. For its own purposes a corporation may even distribute the *total* earnings under the caption "Salaries." But the Department may refuse to treat a part of this amount as a deduction from gross income for tax purposes.

There have been some legitimate reasons for large increases in officers' salaries in the past few years. General price advances, increased effort and strain, larger gross business, and higher net profits—all these conditions tend to justify higher salary scales for the proprietors. An advance of 100 per cent in salaries since 1914 should not be considered excessive as a typical case in view of the general price movement in recent years. Further, where no salaries, or only nominal salaries, were taken in close corporations for the reasons noted above, much greater advances may be justified. Increases in these cases may be called forth by the tax legislation and not by a change in economic conditions but still may be proper in view of the present importance of drawing the line more carefully between distributions of profit and compensation for personal services. The owners can no longer afford to draw their *real* salaries as dividends.

The establishment of any equitable rules or principles of procedure in dealing with such a matter as proprietary salaries would seem at first thought to be almost out of the question. Conditions are highly varied between different companies. In some cases the principal stockholders exercise only the functions of general management; in others the proprietors assume the entire burden of directing operation—financing, production, selling, and general administration. In certain cases the personal efforts of a particular

officer may be absolutely essential to successful operation. Executive ability, technical skill, wide experience in buying and selling—these and other high-class qualifications are found among corporate officials; and consequently a wide range of salaries, including some very high figures, is to be expected. Under these circumstances is it possible to develop any tests of reasonableness which may be applied to a majority of cases?

In Article 105 of Regulations 45 it is stated that "it is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances." In other words a reasonable salary scale for corporate officers (the principal stockholders furnishing services are usually officers) is one which the particular business involved, by comparison with similar enterprises, will warrant. In general a $1,000,000 corporation can afford to pay more (and must pay more) for its executives than a $100,000 company.

As a broad basis from which to proceed this view seems sound enough. Surely the wages of management in a majority of cases cannot be determined entirely apart from the size and complexity of the business as represented by such significant figures as total investment, gross revenue, total costs, and net income. These figures are at least rough *indicia* of the efforts and responsibilities of the officers, and must not be lost sight of in determining reasonable salaries.

This point of view is somewhat different from that commonly advanced by the taxpayer. He is inclined to stress long hours, painstaking attention to the details of the business, early sacrifices and hardships, standards of living, and other subjective conditions entirely apart from the size of the business and the net results of operation. But such considerations, while they may have a bearing, can hardly be said to control. Perhaps even more than in the case of ordinary labor services, values of managerial services are determined by *results* rather than by *sacrifices*. And while it is true that business success or failure may in a particular case be due to economic processes over which the proprietors have little or no control, it is surely also true that in a great many cases superior qualifications and extraordinary efforts lead to success in business

operation as in professional pursuits. Certainly it would not be feasible for any concern to pay salaries very long if there were no earnings from which to make such payments. Similarly physical data, such as the number of units produced, the hours the plant was operated, and so on, cannot be used as the direct criterion of managers' salaries. It is a question of economic, not merely technical, results.

The Department's view further means that the fact, for example, that a particular individual has a bona fide offer of say $50,000 in *another* business, and would be worth that sum *there*, is no guaranty that $50,000 is a reasonable salary for him in his *present* situation. The taxpayer is inclined to believe that such evidence is incontestable, but here again the Department's attitude is equitable. It is a well-known fact that proprietors often remain in business for themselves for years, although earning less than they might receive if working for other companies. The proprietor in such a case may be unable to withdraw the funds invested without serious loss; he may anticipate large profits in the future; or he may prefer to be in business for himself. Whatever the reason, the condition is not uncommon. Similarly college professors often fondly cherish the idea that they *could* earn much more in business or other occupations than in teaching if they cared to take up other lines. Even if this were true it would not of itself prove that particular individuals were thereby worth more *as professors* than they were receiving.

It is a question, then, as to what the size and results of the business justify in the way of salaries. What amount shall be imputed to the capital invested? What part of the earnings can be attributed to the personal efforts of the proprietors? In order to answer these questions the Income Tax Unit has been developing a system of statistical tests based upon a study of a great many cases selected from all types of business. The elements which have been emphasized in this work are gross revenue, total deductions, and net income before deducting proprietors' compensation. Less stress has been placed upon invested capital, partly because this is a somewhat artificial conception under the law and partly because the bases for valuations as between enterprises are so varied as to

make any comparisons on this footing of very doubtful validity. Further, operating figures are more sensitive than capital balances to changes in a situation which may form a reasonable basis for the revision of salaries.

The studies of this question thus far undertaken by the Unit suggest that there *are* certain normal relationships existing in practice between the amount allowed for proprietors' salaries in a given case and gross revenue, net income, and total costs. In other words wages of management seem to be fairly uniform—not closely so, of course—in companies having approximately identical gross sales, costs, and net profits. If this analysis is carried far enough, if an examination is made of say ten thousand representative cases, with subsidiary classifications by industrial and perhaps by regional groups, it should be possible to develop rough criteria of reasonable officers' salaries in the shape of percentage relationships between the total proprietors' compensation in a given case and each of the important operating elements. This sort of analysis will of course throw no light upon the propriety of the salary paid to a particular individual; it would simply give a clue to the *total* amount which could normally be imputed to the proprietors for the function of management in a business showing certain capital and operating conditions.

In applying such percentages to gauge the propriety of salaries in close corporations, however, certain important qualifications must be kept in mind by the auditor if even approximate equity is to be done. In the first place might be noted the fact that, wherever the "personal-service" element enters, percentages based on studies of the operating statements of ordinary manufacturing and mercantile companies are virtually useless. Salaries which absorb an unusually high percentage of net income plus compensation may be justified in such cases.

Further, the scope of the functions performed by the proprietors in close corporations varies widely. In large companies the duties performed by important stockholders, as president, treasurer, secretary, etc., cover much the same range in each case, and are restricted as a rule to general management. In a family corporation, on the other hand, where the stock is owned, let us say, by five brothers,

each is likely to be an "officer," even if the function performed is that of keeping the books or operating a lathe. In one case there may be five salaried proprietors, in another, three, in another but one. Evidently percentages based on comparisons can be applied to such cases only with very great discretion.

A type of case to which general tests can scarcely be applied is that in which the proprietor furnishes some condition in addition to his personal services in the usual sense, such as knowledge of a secret process, the use of a patent, and so on. The salary, so called, may be based largely upon such condition. There may be some question as to whether an individual owning 95 per cent of the stock of a corporation has a right to charge a fat sum to the corporation for a patent, title to which he retains personally, or a secret process, knowledge of which he so retains. Ignoring the corporate entity, such a transaction looks like the transfer of funds from one pocket to another without their passing through the door of taxable income. As far as the writer knows, the Department has issued no special rulings or decisions applying to this point.

In very small corporations it has in general been recognized by the Department that proprietors devoting all their time to the business are entitled to a "living wage" as a minimum allowance regardless of the amount which seems proper from a study of the operating figures. This is a liberal view, as in the unsuccessful company the real economic contribution of the owners may be nil.

Where the salary of a proprietor is based upon a long-standing contract freely entered into by the corporation, and back of which were no influences other than the desire on the part of the stockholders to secure the services of the particular individual involved, the compensation must in general be assumed to be reasonable even if the amount in certain years runs into the millions and absorbs a very unusual percentage of the earnings. The statement is made in Article 105, Regulations 45, that "in any event the allowance for compensation paid may not exceed what is reasonable in all the circumstances"; but it is probable that the Department will recognize the validity of all salary deductions based on bona fide contracts, especially if predating income-tax laws.

To sum up, then, it should be emphasized that the Treasury Department clearly has the right to set reasonable salaries for

proprietors in close corporations, that the general basis which has been adopted is sound, and that the work thus far done suggests that statistical tests can be developed which will form rough guides in a majority of instances. At the best, however, thousands of unusual and special cases will have to be studied individually in detail as they arise.

ACCOUNTING FOR PROPRIETORS' SALARIES

It was stated in the preceding section that prior to the passage of the act of 1917 the practice of setting up allowances for proprietors' salaries was very imperfectly developed, not only in partnerships and sole-proprietorships, but in the case of close corporations as well. In other words, in comparatively few cases were charges entered on the books to cover allowances for owners' salaries in cases where such a procedure would have meant, in effect, that the principal proprietors were paying or allowing salaries *to themselves*.

This is not a surprising situation and does not indicate vicious or even primitive accounting practices. In fact just the reverse is the case. Accounting deals primarily with a record of actual, not fictitious, transactions; and allowances and estimates covering interest on proprietary investment, compensation for the owner's personal services, rent for building furnished by the proprietor, etc., all fall into a class of adjustments of very dubious propriety for ordinary accounting purposes.

The function performed by the proprietors of a typical business enterprise covers several important elements. In all cases it involves the furnishing of capital, with the attendant risks; in all cases it also involves a certain amount of responsibility and final control with respect to the direction of production; in some cases it includes the furnishing of managerial and ordinary labor services. These various phases of the proprietor's function are measurably distinct from the standpoint of economic theory, but in actual practice they are often more or less inextricably tied together. Even the distinction between capital services and personal services is a little hard to make in some cases. The principal proprietor in a large business may take no part whatever in active management; he may perform no ordinary labor services; and yet his function may

be much more complex than that of simply furnishing funds. He may decide certain residual but important questions of policy; his personal reputation may be a large factor in attracting business; his personal credit may be important in securing the funds necessary to carry on the venture. All these are conditions bearing upon business success; and the dividends paid the proprietor in such a case may be said to cover remuneration for these services as well as a return on the capital invested per se.

The economic significance of net proprietary income, then, varies between enterprises according to the nature of the function performed by the proprietors. At one extreme is the stockholder who furnishes funds but no personal services beyond filling out a proxy for the annual meeting of stockholders; at the other extreme is the proprietor of a small retail establishment who works fifteen hours per day at his business, not only carrying the burden of general management but furnishing a large part of the necessary labor services as well. Net income in the first case is largely interest and profits on capital invested; in the second case net income includes an important element of wages.

The owners invest their funds in a variety of commodities and services. The combination of these commodities and services with their own efforts results in a salable product. The cost of producing this product is the expiration of the *purchased* commodities and services. This is the accountant's "expense." The deduction of this expense from gross revenue leaves the net operating revenue. Against this balance must be charged all interest accruing in favor of the various creditors. The remaining figure is net income to the proprietors. Ignoring the problem of taxes, this statement roughly describes the process in which the accountant is interested. The final figure is the share going to the proprietors; and to charge any part of this share against gross operating revenue would obscure the real situation. The owners do not purchase their own personal efforts any more than they do their own capital services. To charge revenue with the estimated value of the services of the principal owners, then, is much the same in principle as charging revenue with proprietary interest and true profits. Proprietary income is composed of various elements, but none of them belong in the expense category.

The values of proprietors' services are, of course, a part of the economist's "cost of production." But so are interest and profits, at least at the margin. The economist is concerned with a whole market situation; the accountant is dealing with specific concerns.

Even before the advent of income and excess-profits taxes some accountants were urging that revenue should be charged with an adequate allowance for the salary of the proprietor or proprietors and with a reasonable interest allowance on the investment. The inclusion of an estimated interest charge on investment as an operating expense is an idea which has been pretty thoroughly exploded for some time. The consensus of opinion among professional accountants has always been opposed to this procedure; and the Bureau of Internal Revenue refuses to admit its propriety. The argument with respect to proprietary salary allowances is perhaps not so clear, but it can be made along the same lines. In sole-proprietorships, partnerships, and incorporated partnerships, where the viewpoint of the accountant must be essentially that of the proprietor's, the charging to expense of an estimated allowance for the personal services of the principal owners means essentially the transfer of an item of net proprietary revenue into the expense classification. If a concurrent credit is made to some other revenue account, as has been sometimes advised, the final effect upon the net-income figure is nil and the procedure is thereby shown to be fictitious. If the proprietors' personal or capital accounts are concurrently credited with the amount of the salary charges, this means that an item of earnings has been transferred bodily from gross revenue to capital without appearing anywhere as an item of net income, and certainly any procedure of this sort is questionable. The proprietor may, of course, actually draw in cash from time to time the exact amount of his salary allowance (although this is rather unusual in sole-proprietorships and partnerships); but if the amount of this withdrawal is a charge against gross rather than net income there is nowhere shown in one figure the total of net earnings available for the proprietors.

Instead of clarifying the situation for the owner this sort of accounting is likely to mislead him. The proprietor of a business wishes first to know what he has made, the net result of his efforts and capital. If he then cares to attempt to divide this net result

into its important economic elements, this is an entirely rational procedure, although there is a question as to the advisability of giving formal effect in the accounts to such division. If entries are made at *this* point (i.e., if net rather than gross income is charged), to appropriate as it were the various important elements of the proprietor's share, no one is likely to be misled. The proprietor's position in the situation is shown more clearly than if a part of the net increase in his ownership is charged to operating expense.

The point is of importance, of course, particularly in the case of sole-proprietorships and simple partnerships. A corporation is a legal entity, and in the case of the open corporation the proprietor as an employee of the company may be viewed as an outsider, while the proprietor as an owner furnishing capital constitutes a part of the corporate membership. Further, in such cases the management is likely to be intrusted to people who actually *are* outsiders, or are at any rate only minor stockholders. In other words, in the open corporation the proprietor is primarily an investor and furnishes little in the way of personal services. Any services he does furnish are *purchased* by the corporation as from one who furnishes no funds whatever. In the close corporation, on the other hand, the corporate entity has less significance; and in cases where the principal owner manages the business it is highly fantastic to say that the business buys the service of the proprietor and that his wage is thereby an expense. For ordinary purposes the accounts are kept on a more substantial basis if such allowances—if made on the books in any form—are treated as distributions of net earnings.

The foregoing discussion ignores the problem of income and excess-profits taxation. As stated in the preceding section such taxes are designed as levies, not upon proprietary net income as such regardless of the type of organization and the functions furnished by the proprietor, but upon a particular element in proprietary income—the return to capital. When, in 1917, the rates on corporations were made higher than the rates on individuals, and, in addition, taxes were levied on "excess" business profits, it became necessary to put the proprietors in different situa-

tions upon roughly the same footing by permitting a deduction for tax purposes equivalent to a reasonable compensation for personal services rendered. This situation, as stated at the outset of this article, tends to modify accounting procedure in that it develops the practice of charging proprietors' salaries to expense even in cases where the proprietors must set their own compensation.

When this practice is fully carried out *taxable* net proprietary income is restricted roughly to a return on capital—interest and profits—in all cases. This condition, while perhaps not vicious, is in a measure unfortunate from the accounting standpoint. It is not the function of accounting to iron out the economic differences between net proprietary incomes in various cases any more than it is the function of accounting to equalize net income between years in a particular case by juggling depreciation charges and resorting to other expedients. The accountant deals with conditions in the specific concern, and endeavors to follow asset values and the distribution of ownership in the same among the proprietors and other interests having equities. Net income will naturally contain different elements in different cases, the nature of this figure depending entirely upon relationships in specific cases. Just as rates of net income to investment vary sharply between businesses, so do the economic elements of which this balance is made up. It is the function of the accounts to register these peculiarities, not to obscure them.

It would be possible to exclude proprietors' salary allowances from operating-expense charges and still organize the financial statements in such a way as not to disturb the integrity of the accounts as a support to the tax return. Ordinary operating expenses could be charged to gross revenue as usual, leaving net operating revenue. From this figure (plus any other income) could be deducted all ordinary tax accruals, interest charges, and any net losses. The balance would be net proprietary earnings, ignoring income and excess-profits taxes. From this sum should be subtracted the allowance for proprietors' salaries, and the result would be net taxable income. In other words, proprietors' salaries can well be deducted for tax purposes without considering such items as operating expense.

In certain cases the proprietors of close corporations may not wish to withdraw large sums of cash from the business as salaries. Indeed, there may be insufficient cash available for this purpose; and the principal owners would doubtless feel in these circumstances that it would be a rather silly procedure for the company to borrow money to pay them salaries. In such cases the amounts deducted for tax purposes would of course be credited to the proprietors' personal accounts—whether the concurrent charges were to gross or net earnings—and these balances would be considered not proprietary items but liabilities. If such amounts were never withdrawn, but were allowed to remain as new investment, they would evidently lose their character as liabilities and become a part of total proprietorship. If salaries were credited in exact proportion to stockholdings such balances could be transferred to surplus in the same manner as items of undivided profits; in all other cases it would be virtually necessary to issue new stock to the various proprietors covering the salary allowances left in the business. Such stock could not be considered a stock dividend for tax purposes, of course, as it would be based upon an item of earnings exempt from tax. The situation is essentially the same as it would be if the proprietors actually withdrew their salary allowances, and then later reinvested the same amounts.

As stated above, sole-proprietors and partners are taxable under the act of 1918 only in their individual capacities, so that the setting up of artificial transactions recording proprietary salaries in such cases is no longer of importance, at least so far as tax returns are concerned. In close corporations proprietors must continue to make such allowances for tax purposes, and the tendency will be to include such items among expenses in the accounts. Such accounting transactions can be considered reasonable by a rigid adherence to the viewpoint of the corporate entity, even if the proprietor in essence votes his own salary; but the more or less artificial character of such transactions should be recognized by the accountant, and there are some reasons at any rate for omitting these items from the operating section of the income sheet.

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